No. 12500

In the United States Court of Appeals for the Ninth Circuit

ALEXANDER & BALDWIN, LIMITED, a Corporation,
APPELLANT

v.

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF THE ESTATE OF FRED H. KANNE, COLLECTOR OF INTERNAL REVENUE OF THE UNITED STATES FOR THE DISTRICT OF HAWAII, APPELLEE

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF HAWAII

BRIEF FOR THE APPELLEE

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
ROBERT N. ANDERSON,
LELAND T. ATHERTON,
Special Assistants to the Attorney General.

RAY J. O'BRIEN,
United States Attorney.

INDEX

CITATIONS

Cases:

Cases—Continued Page

Statutes:

Miscellaneous:

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OPINION BELOW

The opinion of the District Court (R. 14-21) is reported in 76 F. Supp. 133.

JURISDICTION

This appeal involves federal income tax for the year 1932. The tax in dispute was paid as follows: $8,853.06 in tax and $1,863.51 as interest on October 6, 1936. (R. 43.) A claim for refund covering the tax and interest paid on October 6, 1936, was filed on November 27, 1936, and rejected by notice dated November 14, 1940. (R. 44.)

Within the time provided in Section 3772 of the Internal Revenue Code and on July 21, 1942, the taxpayer brought an action in the District Court for the Territory of Hawaii for recovery of the taxes paid. (R. 2-7.) Jurisdiction was conferred on the District Court by the Act of April 30, 1900, c. 339, 31 Stat. 141, Section 86, as amended. Judgment was entered on December 6, 1949. (R. 47-48.) Within sixty days and on February 2, 1950, a notice of appeal was filed by the taxpayer. (R. 50.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether a payment of $50,000 in 1931 to a trust company for the purpose of preventing its financial collapse was merely a contribution rather than the creation of an indebtedness of a kind which may be deducted in 1932 under Section 23(j) of the Revenue Act of 1932 as a bad debt ascertained to be worthless and charged off.

2. Alternatively, whether the $50,000 payment may be deducted as an ordinary and necessary business expense in 1932 under Section 23(a) of the Revenue Act of 1932.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations are printed in the Appendix, *infra.*

STATEMENT

The material facts as found by the District Court (R. 23-41) may be summarized as follows:

The Henry Waterhouse Trust Company, Limited (hereinafter referred to as "Waterhouse"), was a Hawaiian corporation engaged in the trust company business. In 1930 a large part of its assets consisted of real estate and mortgages, and its secretary became

apprehensive that if many calls were made on its demand accounts, due to the effect of the business depression, its condition was not sufficiently liquid to meet its cash requirements. In 1931 it was conducting business as usual, but was encountering some financial difficulties. The Bishop Trust Company (hereinafter referred to as "Bishop"), which had been considering the purchase of Waterhouse's stock for cash, after investigation, advised in 1931 that it would not pay cash for the shares. A. W. T. Bottomley, president of American Factors, Limited, and of a Honolulu bank and vice-president of Bishop, then called a conference of the heads of the principal Hawaiian sugar agencies and banks to present to them the financial condition of Waterhouse and to discuss plans to prevent Waterhouse's forced liquidation. (R. 23-25.)

On February 14, 1931, at a meeting of the directors of Bishop, a plan was presented, largely as a salvage proposition, pursuant to which Bishop would acquire all of Waterhouse's stock without cost and would operate its business for Bishop's own benefit. Cash payments totaling $1,035,000 were to be made to Waterhouse by Bishop, creditors and others. Included in this total figure was a cash contribution of $400,000 to be made by a number of corporations and individuals. Waterhouse's assets and liabilities were to be retained by it and were to be liquidated gradually under Bishop's supervision for a fee of $1,000 per month. Upon final settlement, if any proceeds remained after paying liabilities and expenses, repayment was to be made first to Bishop for any advances made by it in excess of the $1,035,000 cash, and then pro rata to the contributors of the $400,000, together with four percent interest. The objects of the plan were to prevent Waterhouse's failure with its general disastrous effects, to prevent loss on the part of the depositors who

could ill afford to lose, and to enable Bishop to acquire new business. The plan as outlined was approved by Bishop's board of directors and the cash payments mentioned were duly made a few days after February 14, 1931. (R. 25-27.)

Prior to that date, certain corporations, including taxpayer, and individuals had promised to pay to Waterhouse upon consummation of the proposed plan the total amount of $400,000. Taxpayer's contribution was $50,000. The total amount was actually paid to Waterhouse by the corporations, including taxpayer, and individuals as promised by them. For these contributions Waterhouse's notes bearing interest at four percent were given, subject to being paid however only after other liabilities and expenses of Waterhouse were paid, as provided in the plan and as outlined by Waterhouse in letters to the contributors. (R. 27-34.) The note for $50,000 issued to taxpayer by Waterhouse was dated February 21, 1931, and contained the provision that (R. 34):

> * * * payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.

Taxpayer was not a stockholder of Waterhouse. (R. 35.)

An audit report dated March 31, 1931, listed the book value of Waterhouse's assets as of February 14, 1931, as $4,820,090.92, and the book value of its liabilities, exclusive of capital and surplus, on that date as $4,149,437.06. The audit report stated that the reserve for losses of $680,803.15 and the special contingent reserve of $400,000 were considered adequate to cover probable losses in the realization of assets and liquidation of liabilities. At December 31, 1931, Waterhouse

had actually sustained on liquidation a loss of $324,-913.77 and at December 31, 1932, a cumulative loss of $410,345.80, so that at the end of 1932 there remained a balance of $190,457.35 in the reserve for losses, against which future losses would be charged before there would be an impairment of the special contingent reserve for repaying the $400,000 contributions to the special noteholders. (R. 35-40.)

The $50,000 note received by taxpayer was contingent as to payment and subject to such conditions as to render it nonnegotiable at that time and thereafter, and without negotiable value at any time. There is no evidence that taxpayer would have suffered any loss if it had not attempted to keep Waterhouse a going concern. The considerations flowing to taxpayer for its contribution of $50,000 were the protection of the commercial community, sympathy toward clients of Waterhouse who could not afford to lose, and other commendable desires and motives of helpfulness and security. (R. 40.)

In 1931 taxpayer charged off on its books $25,000 of the face amount of the $50,000 note, but did not take a deduction therefor in its income tax return for that year. In 1932 taxpayer charged off on its books the balance of $25,000 of the face amount of the note and claimed as a deduction the entire amount of $50,000 as a bad debt in computing its taxable net income for 1932. (R. 41.)

The District Court concluded that the payment of $50,000 to Waterhouse in 1931 was only a contribution; that the note given to it in acknowledgment of the contribution was not a debt; and that no part of the $50,000 was deductible in 1932 as a bad debt ascertained to be worthless and charged off within the terms of Section 23(j) of the Revenue Act of 1932. The District Court further held that no part of the $50,000

was deductible as a loss sustained in 1932 under Section 23(f) of the 1932 Act. (R. 45.)

SUMMARY OF ARGUMENT

The $50,000 contributed to the Waterhouse fund in 1931 is not deductible in 1932 as a bad debt ascertained to be worthless and charged off in that year under Section 23(j), Revenue Act of 1932. The $50,000 note received by taxpayer from Waterhouse was not payable at all events but its payment was contingent on Waterhouse having funds to pay it after all of its other liabilities and expenses had been paid. Moreover, the $50,000 was paid by taxpayer as a contribution to serve the community generally and without expectation of repayment. Under the authorities, both of these circumstances require the conclusion that no debt sufficient to support a deduction under Section 23(j) was created.

Furthermore, assuming *arguendo* only that a valid debt was created, the taxpayer failed to prove facts sufficient to enable the District Court to determine that taxpayer's alleged ascertainment of worthlessness of the debt in 1932 was based on facts warranting that conclusion. Moreover, the record strongly indicates that taxpayer did not deem the "debt" worthless in 1932, assuming *arguendo* that it ever believed the note had value, since it declined to concede its worthlessness for other purposes.

The $50,000 paid in 1931 is not deductible as an ordinary and necessary business expense in 1932. While the payment is not an ordinary or necessary business expense, even if it were so considered, it accrued in 1931 at the time it was incurred and paid and could not be deducted in 1932 under Section 23(a).

ARGUMENT

The District Court Did Not Err in Denying the Taxpayer a Deduction in 1932 for the Payment in 1931 of $50,000 into the Fund for the Henry Waterhouse Trust Company

A. *The payment of $50,000 did not create a valid debt*

It is elementary that the allowance of a deduction for a bad debt presupposes the existence of a valid debt arising out of a debtor-creditor relationship. *Harmount* v. *Commissioner,* 58 F. 2d 118 (C.A. 6th); *Milton Bradley Co.* v. *United States,* 146 F. 2d 541, 542 (C.A. 1st); *Estate of Van Anda* v. *Commissioner,* 12 T. C. 1158, 1162. The giving of a note or other evidence of indebtedness which may be legally enforcible is not in itself conclusive of the existence of a bona fide debt. *Montgomery* v. *United States,* 23 F. Supp. 130 (C. Cls.), certiorari denied, 307 U. S. 632; *Estate of Van Anda* v. *Commissioner, supra; Wolff* v. *Commissioner,* 26 B.T.A. 622; *Griffiths* v. *Commissioner,* 25 B.T.A. 1292; *Hayes* v. *Commissioner,* 17 B.T.A. 86.

A conditional obligation does not give rise to a debt. *Shiman* v. *Commissioner,* 60 F. 2d 65, 66 (C.A. 2d); *Milton Bradley Co.* v. *United States, supra,* p. 542; *S. Naitove & Co.* v. *Commissioner,* 32 F. 2d 949 (C.A. D.C.); *Wolff* v. *Commissioner, supra,* p. 626. This principle was explained by the First Circuit in the *Milton Bradley Co.* case as follows (p. 542):

> One of the underlying conditions of validity is an unconditional obligation of the debtor to pay the creditor. "The debts which the statute permits to be charged off when ascertained to be worthless are debts where there is an obligation of the debtor to pay and a right of the creditor to receive and enforce payment." *J. S. Cullinan* v. *Commissioner of Internal Revenue,* 19 B.T.A. 930. "The sine qua non of a debt is the obligation to pay. * * * And this means not a contingent obligation, * * *." *Wolff* v. *Commissioner of Internal Rev-*

enue, 26 B.T.A. 622, 626, and cases cited. The liability to pay in the future, contingent upon something which may or may not occur, is not indebtedness, and the taxpayer may not treat as worthless debts amounts which are at a particular time merely contingent liabilities. *Eckert* v. *Burnet,* 1931, 283 U. S. 140, 51 S. Ct. 373, 75 L. Ed. 911; *S. Naitove & Co.* v. *Commissioner of Internal Revenue,* 1929, 59 App. D.C. 53, 32 F. 2d 949; *Wolff* v. *Commissioner, supra.* Where the liability to pay is not absolute, the existence of a deductible debt has not been accepted. *Howell* v. *Commissioner of Internal Revenue,* 8 Cir., 1934, 69 F. 2d 447, certiorari denied; *Howell* v. *Helvering,* 1934, 292 U. S. 654, 54 S. Ct. 864, 78 L. Ed. 1503; *American Cigar Co.* v. *Commisioner of Internal Revenue,* 2 Cir., 1933, 66 F. 2d 425, certiorari denied 133, 290 U. S. 699, 54 S. Ct. 209, 78 L. Ed. 601; *In re Park's Estate,* 2 Cir., 1932, 58 F. 2d 965, certiorari denied, 1932, *Park's Estate* v. *Commissioner of Internal Revenue,* 287 U. S. 645, 53 S. Ct. 91, 77 L. Ed. 558. * * *

The District Court in this case concluded (R. 45) that the payment of $50,000 to Waterhouse in 1931 was just a contribution by taxpayer, that the note given was contingent as to payment and subject to such conditions as to render it without negotiable value at any time, and that it therefore cannot be dealt with as a debt. If the note was contingent as to payment, the District Court was manifestly correct under the cited authorities[1] in concluding that it was not a "debt"

[1] The cases of *Clay Drilling Co.* v. *Commissioner,* 6 T. C. 324, and *Western Woodwork & Lumber Co.* v. *Commissioner,* decided May 9, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,124), are cited by taxpayer (Br. 14-16) as authority to the contrary. The issue in the *Clay* case was whether a valid indebtedness had been cancelled and forgiven in an earlier year as a result of an agreement under which the debt became payable only in the manner agreed upon. The Tax Court held that it was not cancelled. While the *Western* case did apparently rule that a note represented a debt despite the contingent nature of its payment, no deduction

which can be the basis of a deduction for a bad debt under Section 23(j) of the Revenue Act of 1932 (Appendix, *infra*).

It is plain that the finding that the note was contingent as to payment could not be successfully challenged, and the taxpayer does not attempt to do so. The note given to taxpayer by Waterhouse had a proviso which read (R. 34)—

> * * * payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.

The conditions stated in the letter (R. 28-34) were that payment was to be made only after expenses of the liquidation, $1,000 per month to Bishop for supervision, interest, indebtedness, and other liabilities were paid in that order, and after Bishop was reimbursed for the amounts contributed by it, if any, required (in excess of the $1,035,000) to liquidate Waterhouse's liabilities. The fact that the note was not absolute as to payment is alone enough to require the finding that no debt sufficient to support a deduction under Section 23(j) was created.

Moreover, it has been repeatedly held that advances voluntarily made without expectation of repayment do not create a "debt" which can provide the basis for a bad debt deduction. *Spring City Co.* v. *Commissioner,* 292 U. S. 182, 189; *Porter* v. *United States,* 27 F. 2d 882 (C.A. 9th); *American Cigar Co.* v. *Commissioner,* 66 F. 2d 425 (C.A. 2d), certiorari denied, 290 U. S. 699; *W. F. Young, Inc.* v. *Commissioner,* 120 F. 2d 159 (C.A. 1st); *Busch* v. *Commissioner,* 50 F. 2d 800

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for a bad debt was allowed in 1943 because the note became worthless in an earlier year. To the extent that the unreviewed memorandum opinion of the Tax Court in the *Western* case is contrary to the authorities cited above, it is against the clear weight of authority and is, we submit, incorrect.

(C.A. 5th); *Menihan* v. *Commissioner,* 79 F. 2d 304 (C.A. 2d); *Hayes* v. *Commissioner,* 17 B.T.A. 86, 87; *Wolff* v. *Commissioner,* 26 B.T.A. 622; see particularly, *Davis* v. *Commissioner,* decided November 3, 1937 (1937 P-H B.T.A. Memorandum Decisions, par. 37, 312); *McLeod* v. *Commissioner,* 19 B.T.A. 134, 139.

That principle is applicable here in support of the conclusion that no real debt was created. The District Court found that the payment of $50,000 was merely a contribution without expectation of repayment, other than preventing Waterhouse from closing due to its insolvent condition and protecting the commercial community and Waterhouse's clients who could ill afford to lose. (R. 40, 45.) These findings are clearly correct when all the circumstances existing at the time that taxpayer was solicited to contribute to the fund and agreed to do so are taken into account. Although taxpayer argues (Br. 10-18) that the findings in this respect are erroneous, the testimony of the witnesses relied on (Br. 12-13) at most indicates that some of those who contributed expected and hoped that some part of the contributions would not be needed and would be returned. Facts with respect to Waterhouse's financial position in 1931 to support such a hope were not shown; the Waterhouse balance sheet and the audit report prepared at the time based on book figures (R. 35-40) were not shown to represent the actual value of the assets. And, it is obvious from the whole record that the contributions were made for the principal purpose or motive of preventing Waterhouse's failure, irrespective of whether the contributions might be returned in whole or in part. Indeed, taxpayer apparently concedes (Br. 16) that the motive for paying the money to Waterhouse was the protection of the commercial community as the District Court found, but argues that the reason for making the advance and its wisdom

from the standpoint of being repaid are not pertinent. Such matters of course are material on the question of whether the payment was voluntarily made without expectation of repayment, and the District Court's finding here on that question is amply supported and is correct.

There is no evidence that taxpayer would have lost anything through Waterhouse's failure if it had not contributed to the fund, as the District Court found (R. 40), and the contribution was not therefore required to protect an existing indebtedness, investment or claim against Waterhouse. This is additional confirmation that the contribution was voluntarily made.

It is submitted that the District Court's finding that the taxpayer's payment of $50,000 into the Waterhouse fund was not a debt was correct and should be affirmed.

B. *The debt was not ascertained to be worthless in 1932*

The District Court concluded that no part of the $50,000 was deductible as a bad debt ascertained to be worthless and charged off within the taxable year 1932 within the terms of Section 23(j) of the Revenue Act of 1932. (R. 45.)

Even if it is assumed, *arguendo* only, that the payment of the $50,000 into the Waterhouse fund created a valid debt, we believe the evidence clearly supports the District Court's conclusions stated above. The record discloses that a reserve of $680,803.15 was set up on the books of Waterhouse as at February 14, 1931, after the reorganization against which all liquidating and operating losses were to be charged. (R. 39.) The District Court made a finding of fact (to which the taxpayer does not express any disagreement) which reads as follows (R. 40):

> At December 31, 1931, Henry Waterhouse Trust Company had sustained on liquidation actual

losses amounting to $324,913.77, and at December 31, 1932, it had sustained on liquidation cumulative actual losses totaling $410,345.80 so that at the end of 1932 there was still a balance of $190,-457.35 remaining in the Reserve for Losses, against which future losses must be paid before there would be any impairment for the repayment of the $400,-000.00 contributions to the special noteholders.

Nevertheless, the taxpayer asserts (Br. 17-18) that by the end of 1932 it became apparent to it that, by reason of the further reduction in the value of the assets out of which the notes were to be paid, the note held by it was valueless and was charged off as a loss on its books. As a matter of fact, the taxpayer charged off $25,000, or one-half of the face amount of the note, as worthless in the year 1931, and the balance in 1932. (R. 41.)

The taxpayer refers to the testimony of Messrs. Lowrey, Castle and Linden (Br. 17), but we submit that their testimony merely indicates that the taxpayer relied upon the opinions of others without investigation and proof of the facts upon which their opinions were based. It is a fundamental rule that mere statements of opinion as to worthlessness are insufficient to satisfy the statutory requirements, and that the facts with respect to the alleged valuelessness of the notes must be presented to the court so that it may form an independent judgment as to the ascertainment of worthlessness. *Rosenthal* v. *Helvering,* 124 F. 2d 474 (C.A. 2d); *Georgia Engineering Co.* v. *Commissioner,* 21 B.T.A. 532, 547-548; *Gano* v. *Commissioner,* 19 B.T.A. 518. This Court in *American Trust Co.* v. *Commissioner,* 31 F. 2d 47, held that an investigation which shows only that the debtor is in an unsatisfactory financial condition and that the collection of the debt is doubtful, is not a sufficient ascertainment of worthlessness. So, we submit that the testimony of these indi-

viduals is not a sufficient showing of worthlessness.

Despite the assertion to the contrary made in the taxpayer's brief (pp. 17-18), we submit that the evidence of record indicates clearly that the taxpayer could not have been convinced that the note had become valueless in 1932, assuming *arguendo* of course that taxpayer ever believed that the note had value.[2] As the District Court found, at the end of 1932 the reserve for liquidating losses had not been exhausted. (R. 40.) Also the letter from Waterhouse in 1932 contained the following (R. 90):

> Despite the worthlessness of the note it remains an apparent liability of this Company and operates as a hindrance to its speedy liquidation, especially as so long as it remains on our books the Advisory Committee will have to be continued. *Hence we suggest that you concede the worthlessness of the note by formally authorizing this Company to consider that it is no longer an obligation.* (Italics supplied.)

It was stipulated that the advisory committee was not abrogated but continued to function as usual during the balance of 1932 and the year 1933. (R. 68.) Lowrey testified that the taxpayer did not make a formal reply to the Waterhouse letter. Not only did the taxpayer refuse to comply with the request of Waterhouse that it formally concede that the note was worthless and surrender it to Waterhouse, but the other noteholders likewise refused to do so. Yet, for federal income tax purposes, the taxpayer seeks relief here on the ground that it ascertained the note to be worthless in 1932, having refused, however, to make such a concession to Waterhouse. The fact that it charged off the note as a loss on its books is insufficient. *Spring*

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[2] The District Court noted in its opinion that the taxpayer knew of the insolvency of Waterhouse at the time it made the $50,000 contribution in 1931. (R. 16.)

City Co. v. *Commissioner,* 292 U. S. 182, 189. Further more, the charge off it made does not support its con tention that the note was ascertained to be worthles in 1932 for, as pointed out above, it charged off $25,000 or one-half of the face amount of the note, as worth less in the year 1931, and the balance in the following year. (R. 41.)

In view of the foregoing, we believe the Distric Court's conclusion that no part of the $50,000 was de ductible as a bad debt ascertained to be worthless and charged off within the taxable year 1932 is fully sup ported by the evidence and should be sustained.

C. *Neither is the $50,000 paid to Waterhouse deducti ble as an ordinary and necessary business expens of the taxpayer in 1932*

In the alternative, the taxpayer maintains (Br 18-26) that the District Court should have allowed i to deduct the $50,000 as an ordinary and necessary business expense in the year 1932.[3]

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[3] It should be noted that the taxpayer's refund claim (Deft Ex. 3) did not contain any allegation that this payment was deductible as an ordinary and necessary expense of carrying on the taxpayer's business. Hence, we submit, the taxpayer may not raise here that issue. *United States* v. *Felt & Tarrant Mfg. Co.,* 283 U.S. 269; *Red Wing Malting Co.* v. *Willcuts,* 15 F. 2d 626, 634 (C.A. 8th), certiorari denied, 273 U.S. 673; *Lynch* v. *Rogan,* 50 F Supp. 356, 357 (S.D. Cal.); *Kemper Military School* v. *Crutchley,* 274 Fed. 125, 128 (W.D. Mo.).

In this connection, it is also interesting to note that the taxpayer in the "Statement of Points Upon Which Appellant Intends to Rely on Appeal" (R. 95-96), at paragraph 6 thereof, alleges error on the part of the District Court in concluding that no part of the $50,000 payment was deductible as "a *loss* sustained during that taxable year [1932]", whereas in its brief (p. 8) under the "Specification of Errors Relied on", the taxpayer at paragraph 6 thereof abandons its allegation of error respecting the disallowance of the deduction claimed as a loss, and substitutes therefor as a new allegation of error that the District Court erred in concluding that no part of the $50,000 payment was deductible as "an ordinary or necessary expense of carrying on its business for the year 1932."

Section 23(a) of the Revenue Act of 1932 (Appendix, *infra*) permits deduction of only the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any business. There is no evidence to support a conclusion that the expenditure of the $50,000 was an ordinary and necessary expense of carrying on the taxpayer's business during the taxable year 1932. It was not usual and customary in the agency and factoring business to make a contribution of this sort nor was it necessary for taxpayer to do so. On the contrary, the contribution was extraordinary in nature. Moreover, the record shows that the money was paid into the fund in 1931 (R. 15-16, 40, 76-77), the taxpayer having in that year unconditionally promised to pay the amount of $50,000 to Waterhouse (R. 27). As the taxpayer's books are kept on the cash basis of accounting and its federal income tax returns have at all times been on that basis and on the calendar year (Br. 2-3; R. 71), it could not deduct this expenditure, or any part of it, as an expense of doing business in the calendar year 1932, since its liability became fixed in the year 1931 when the payment was actually made.

In *Robert Gaylord, Inc.* v. *Commissioner,* 41 B.T.A. 1119, and *Moloney Electric Co.* v. *Commissioner,* 42 B.T.A. 78, relied on by taxpayer here (Br. 20-23), the Tax Court reached a conclusion on the facts there that the payments involved could be deducted as an ordinary and necessary business expense in 1936. The amounts in question there were actually paid in 1936, the year in which allowed, although they had been deposited in a bank in 1931 where they were held, drawing interest, until needed by the bank being liquidated. Thus, those decisions, whatever view is taken as to their validity, are not authority for allowing the deduction to this taxpayer in 1932, where the liability for the

contribution accrued and the contribution was paid in 1931.

Virginia Engineering Co. v. *United States* (E.D. Va.), decided June 16, 1943 (32 A.F.T.R. 1751, 1753), discussed in taxpayer's brief (pp. 23-25) is distinguishable from the instant case in that the trial court in that case made a specific finding that the amount advanced to the Schmetz fund was made "in an effort to protect petitioner's *vital* interests." (Italics supplied.)

A careful reading of the decision in *First Nat. Bank & Trust Co. of Tulsa* v. *Jones,* 143 F. 2d 652 (C.A. 10th), discussed by taxpayer's counsel (Br. 25-26), discloses that the premiums taken as a deduction there were paid by the bank on insurance policies left with it as collateral for loans made in the conduct of its business, so the premiums clearly were ordinary and necessary expenses of carrying on its business. The situation in the instant case is so different that that case is not apposite here.

The taxpayer has the burden of bringing the deduction sought by it clearly within the terms of the applicable statutory provision. This the taxpayer has failed to do here.

In view of the foregoing, we submit that the District Court's conclusions were correct and should not be disturbed.

CONCLUSION

The decision of the court below as to the nondeductibility of the $50,000 contribution to the Waterhouse fund on the undisputed facts of the case was correct and therefore should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
ROBERT N. ANDERSON,
LELAND T. ATHERTON,
Special Assistants to the Attorney General.

RAY J. O'BRIEN,
United States Attorney.

AUGUST, 1950.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * *

(f) *Losses by Corporations.*—Subject to the limitations provided in subsection (r) of this section in the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year * * *

* * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", depend-

ent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 121. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 141-272. * * *

ART. 171. *Losses.*— * * *

Subject to the limitations on losses from sales or exchanges of stocks and bonds provided in section 23 (r) and article 272, losses sustained by corporations during the taxable year and not compensated for by insurance or otherwise are also fully deductible.

Losses must usually be evidenced by closed and completed transactions. * * *

* * * * *

ART. 191. *Bad debts.*— * * *

Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some

other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. * * *

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ART. 321. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 331-333.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 341. *"Paid or incurred" and "paid or accrued."*—The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in Title I must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of

a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

ART. 342. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. (But see section 117 and articles 651-655.) A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. * * *

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